

## **FIRST QUARTER 2016**

It's easy to get the impression that the 2016 presidential contest is the only newsworthy event in the world right now; it certainly is the dominant focus of most media outlets. However, while the candidates fight their way toward their respective conventions, the rest of the world continues on. In the sections below, we discuss proposed rules the Department of Labor issued just last week (and were six years in the making) that now require the financial services industry to uphold a fiduciary standard of care when advising on retirement assets. We also highlight significant economic activity, both domestic and global, that is relevant to investors. Finally, in our Planners Corner, we offer a call to action with regard to Social Security benefits as the new, more restrictive rules, take force April 29, 2016. We hope this letter finds you happy and healthy, and looking forward to the coming summer months.

### **CONFLICT OF INTEREST AND THE PROPOSED DOL RULE**

Toby Levitt and John Bird started Albion Financial Group over three decades ago with one simple tenet: "There should be a financial advising firm fully focused on the client". Albion's commitment to clients resonated with people and now, thirty plus years later, Albion is privileged to manage nearly \$1 billion on behalf of approximately 500 families.

The world is quite a bit different today than it was in 1982 when Albion was founded. We have the internet, self-driving cars and supercomputers that fit in our pockets. Sadly, one aspect of today's economy has not changed: Today - as in 1982 - most brokers are simply salespeople highly incentivized to sell product.

*The most difficult thing is to recognize that sometimes we too are blinded by our own incentives. Because we don't see how our conflicts of interest work on us - Dan Ariely*

In an ideal world, consumer behavior drives needed changes in industry. When that doesn't happen and atrocities continue unchecked for too long, the government has to step in. On April 6, 2016, the Department of Labor published their proposed fiduciary rule to help protect retirement savers. The core of this rule is the requirement of those who offer advice and investment management services related to retirement plans to put their client's interests first: the *fiduciary standard*. It often comes as a surprise to consumers that their financial advisor is not held to a fiduciary standard. Instead, most advisors are held to a *suitability standard*, meaning they are required to recommend investments that are "suitable" for the specific client. Since inception Albion has adhered to the fiduciary standard. We have *always* believed it is the right thing to do.

*November 19, 2013 - Justice Department, Federal and State partners secure record \$13 billion global settlement with JPMorgan for misleading investors about securities containing toxic mortgages.*

*March 7, 2016 - Investment News - Study finds extensive misconduct; Nearly 20% of advisers at Oppenheimer have been disciplined.*

'What's the difference?', you might ask. The following example may help: A broker operating under a suitability standard identifies a mutual fund that would be a good fit for his client, but the fund has several different share classes. The A shares have a front end sales charge (typically 5%) that is deducted from the investor's balance. *In addition*, the investor will pay an annual sales charge (12b-1 fee) that is typically 0.25%. The B shares do not have a front end sales charge, but they *do* have a larger annual sales charge - typically 1.0% - *as well as* a contingent deferred sales charge should you sell the shares prior to the end of a certain time period- often six years. Then there are the I shares that have no sales charges - no front end charges, back end charges or ongoing 12b-1 charges. The only fee associated with I shares(which is also a fee assessed on the A and B shares), is the management fee that covers the actual cost of investing the fund assets. Note that these fees are largely

invisible to the client; it is a payment made directly from the mutual fund firm to the selling advisory firm.

*Thursday, August 21, 2014 - Bank of America to pay \$16.65 billion in historic Justice Department settlement for financial fraud leading up to and during the financial crisis*

When operating under the suitability standard, the financial advisor can steer their client toward any of these share classes, as the investment approach is the same for all of them. Under the fiduciary standard, however, the advisor *must* use the I shares, as that share class is clearly in the client's best interest.

*March 28, 2016 - Morgan Stanley ordered to pay \$34 million to the estate of Roy M. Speer for inappropriate behavior (Morgan Stanley generated about 12,000 transactions between January 2009 and June 2012 in the account of an elderly client who suffered dementia).*

But is the DOL fiduciary rule change really necessary? Don't the brokerage firms and their advisors always operate in their clients' best interests? Unfortunately the answers are yes and no – yes, the change is necessary, and no, brokerage firms and their advisors do not always operate in the best interests of their clients. Most brokerage firms are populated by individuals – both management and advisors – who strive to do what is right for their clients. But, unfortunately, every week we see articles in our industry press about advisors and brokerage firms who are settling with clients and/or the Securities and Exchange Commission for taking advantage of customers:

*March 28, 2016 - Three AIG brokers fined \$7.5 million for selling high-cost funds when an equivalent low cost option was available. Sold share classes with 12b-1 fees rather than lower fee share classes.*

As more details emerge on the new Department of Labor regulation over the coming weeks, we will be working to make sure what we do at Albion is not only what is in the client's best interest but also complies with any new requirements that may emerge.

Unfortunately, not everyone is able to see that it takes effort to find our own conflict of interest blind spots:

*If I, taking care of everyone's interests, also take care of my own, you can't talk about a conflict of interest - Silvio Berlusconi*

Yikes!

### Economy and Markets

*"The truth is that markets are more like a roller coaster ride than a cruise." - Vivek Wadhaw*

In the first quarter, global stock markets experienced a rather intense white-knuckle thrill-ride. Out of the gate, chaos from China (mostly yuan driven), general global growth concerns, geopolitical punch-ups in the Middle East and North Korea, and fears of an imminent US recession sank equities in one of the worst annual starts in history. By the last week of January, however, an unusual rally emerged, led by low quality, left-for-dead, fundamentally challenged stocks in the market - energy, materials, industrials, *and* richly-valued high dividend payers in utilities, telecom, and consumer staples sectors. This odd mixture of investors sifting through the rubble to buy both junkier and defensive names left behind the stocks of health care, financials, and growth technology industries, despite their sundry of merits. Health care, for example, is projected to record the best revenue growth in 2016 of all ten S&P 500 sectors and is likely to finish in the top three for earnings growth.

As the calendar turned to February and March, these lower quality slices of the market continued their rally, leading the market higher, while many of the market's most fundamentally sound stocks largely sat out this rebound. When the dust cleared, most major indices had traveled much ground in the first quarter only to settle somewhere between modestly lower to just a bit better than flat. In this tale, Rip Van Winkle

would have missed abundant action during his short snooze, yet awakened to find little had changed.

Unfortunately, our crystal ball can neither see nor predict the erratic nature of near-term money flows and sentiment shifts on Wall Street. What we *can* control is doing what we've done well for nearly 34 years - own financially sound companies with good products / services sporting competitive advantages that are run by deft managers. This is the fountain which serves up growth in sales, earnings and cash flows over time. Virtually all of the companies we own are seeing improving fundamentals and their businesses are progressing well. Indeed, it is these key parameters that matter most in driving stock prices and returns higher over the long-run.

We continue to think the risk of a U.S. recession remains low, and if the economic recovery is not ending anytime soon, a sustained bear market in stocks is unlikely. We wrote about this very notion a few months back on our blog during (what we see now in hindsight) the most frightening point in the sell-off. U.S. economic policies are not recessionary. The Treasury yield curve remains positively-sloped, rates remain low, and the money supply continues to expand at a steady clip, all thanks to the Fed's easy monetary policy - a stance we expect to continue for the foreseeable future.

There are also scant current excesses evident in the economy. Consumer spending has been steady but measured and has been accompanied by increasing household savings rates. Household debt servicing ratios are near record low levels, while net worth has reached record highs. Businesses are not behaving in reckless ways, as verified by moderate capital spending levels and capital utilization rates below 80%. Meanwhile job growth continues to impress amid tame inflation, and the bulky US services sector continues its expansion.

In sum, balance sheets across the economy are strong; consumer spending and attitudes are cautiously optimistic; credit growth and delinquency rates are low; and corporate profits are increasing (with the exception, broadly speaking, of the impact on certain sectors of dramatically lower oil prices and a strong dollar).

What about the rest of the world?

China continues its gentler growth trajectory as foreign direct investment slows, returns on debt-financed growth wanes, and domestic consumption - as opposed to export centric growth - becomes paramount. These are long wave shifts in their economic structure and will take time to fully develop. In the interim, we are neither cheerful nor glum on Chinese economic data.

In Japan, monetary and fiscal authorities remain committed to throwing everything but the kitchen sink at their economy in an effort to resuscitate it from its flat lined condition, including newly introduced negative nominal interest rates.

In Europe, the ECB is going full bore with its own stab at negative rates, which now dominate the first 5-8 years of the yield curve for a few of its major economies. Concurrently, growing anxieties waft from the UK as we approach the country's June 23<sup>rd</sup> vote to determine their future as part of the EU project. India seems to be accelerating, but has deep political and structural challenges. And Russia continues to clearly demonstrate that it is an antiquated power in secular decay with energy its only lifeline (but only when prices are going up!). Considering the above, we expect blended growth in world output to march forward another +2-3% this year.

In the face of this sanguine view, there are also vulnerabilities in the stock market that we are tirelessly monitoring. The U.S. corporate earnings cycle is more mature at this point, along with profit margins, and wage costs may finally begin to increase in earnest as the labor economy tightens, further squeezing business income statements. If wage pressures accelerate, the Fed may normalize monetary policy more quickly by raising interest rates in order to stem inflation. And while this may not crush the bull market (with Fed Funds currently at -0.37%, there is plenty of room for increase before interest rates get tight), it could render its trajectory more rocky and unclear. Valuation, the multiple investors are willing to pay for earnings, sits at about 17x 2016 earnings estimates. This level is not cheap, but it is also not dear,

especially when juxtaposed against the ultralow interest rate environment and near zero rates on cash balances. Either way, it is important to remember that bull markets rarely end simply because valuations are perceived as *fair* or *slightly extended*. Rather, it is typically economic recession that ushers in the bear, an occurrence we don't currently anticipate.

On net, we remain prudently optimistic on stocks and continue our efforts to find and own high quality investments for our clients. Markets ebb and flow, but finding and owning a slice of first-rate American businesses endures.

### **Planners Corner**

Be aware the revised Social Security rules are set to take effect April 29, 2016 - just days from now. We have reached out several times to our clients directly to inform you of this change, but in the off chance you are still not aware of your options, time is getting short. These rules are applicable to couples who may benefit from the file and suspend and restricted application strategies. If you are not currently collecting Social Security, are married or have been married, were born prior to May 2, 1950, and have not yet reviewed your options, please reach out to us as soon as possible. If you were born prior to January 2, 1954, there are also options you should consider prior to the deadline. The

strategies that will no longer be available are powerful planning tools which, fortunately, we've been able to bring to bear on several client situations. One client couple was able to implement the file and suspend strategy. The result is the lower earning spouse is now collecting her spousal benefit; half of her husband's full retirement benefit; while allowing both of their eventual benefits to keep growing at approximately 8% per year (plus the cost of living adjustment) until they reach age 70. So don't delay - Act now to find out if this applies to you! You may have friends or family members to whom this deadline also applies. If this is the case please encourage them to reach out to us so we can help them evaluate their options before the deadline.